1963

Auditing standards and procedures; Statements on auditing procedure, No. 33

American Institute of Accountants. Committee on Auditing Procedure

AUDITING STANDARDS AND PROCEDURES

STATEMENTS ON AUDITING PROCEDURE NO. 33

Issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants

NOTES

Unless otherwise indicated, Statements on Auditing Procedure present the considered opinion of the twenty-one members of the committee on auditing procedure, reached on a formal vote after examination of the subject matter by the committee and the technical services division. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the statements rests upon the general acceptability of the opinions so reached.

The committee on auditing procedure is the senior technical committee of the Institute designated to express opinions on auditing matters. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the committee's recommendations must be assumed by those who adopt other practices.

AUDITING STANDARDS AND PROCEDURES

AMERICAN
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Foreword

This statement is a consolidation of, and is intended to replace, the following pronouncements of the Committee on Auditing Procedure: Internal Control (1949), Generally Accepted Auditing Standards (1954), Codification of Statements on Auditing Procedure (1951), and Statements on Auditing Procedure No. 25-32 (issued on various dates after 1951). It incorporates the substantive matters covered in the earlier pronouncements which the committee believes are of continuing interest to the independent auditor.

The subject matter is presented in four sections. The first section deals with the responsibilities and functions of the independent auditor, and sets forth in chapter 2 the generally accepted auditing standards as adopted by the membership of the American Institute of Certified Public Accountants. In the following three sections pertinent portions of earlier pronouncements of the Committee are related to the three classes of standards: those of a general nature, the standards of field work, and those on reporting.

This statement is essentially a codification of the substance of the earlier committee pronouncements, eliminating duplicated material. However, in certain instances, for example, chapters 4, 6 and 11, the commentary has been expanded and clarified; in chapter 12, Long-Form Reports, the original Statement has been strengthened with a definite recommendation that the independent auditor should clearly establish his position regarding data other than the basic financial statements included in long-form reports; and the paragraph dealing with opinions on prior year's statements in chapter 10 had also been strengthened by a recommendation that where prior year financial statements are presented for comparative purposes, and the independent auditor has not made an examination of such financial statements, there should be appropriate disclosure in the financial statement or in his report.

This statement is not intended to apply to the functions of independent auditors insofar as they relate to tax practice and management services.

Committee on Auditing Procedure 1962-63

December 10, 1963

The statement entitled "Auditing Standards and Procedures" was adopted unanimously by the twenty-one members of the committee.

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CHAPTER I

Responsibilities and Functions of the Independent Auditor

1. The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position and results of operations. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted principles of accounting and whether such principles have been consistently applied in the preparation of the financial statements of the current period in relation to those of the preceding period.

Distinction Between Responsibilities of Auditor and Management

2. Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through

financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on the management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of the management.

Professional Qualifications

3. The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified to engage in another profession or occupation. For example, the independent auditor, in observing the taking of a physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately rely upon the advise of attorneys in all matters of law.

4. In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.

Detection of Fraud (including defalcations and other similar irregularities)

5. In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and

his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

6. Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively. In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations but also by the possible deterrent effect upon employees; the presence of fidelity bonds, however, should not affect the scope of the auditor's examination.

7. When an independent auditor's examination leading to an opinion on financial statements discloses specific circumstances that make him suspect that fraud may exist, he should decide

whether the fraud, if in fact it should exist, might be of such magnitude as to affect his opinion on the financial statements. If the independent auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding with the proper representatives of the client as to whether the auditor or the client, subject to the auditor's review, is to make the investigation necessary to determine whether fraud has in fact occurred, and, if so, the amount thereof. If, on the other hand, the independent auditor concludes that any such fraud could not be so material as to affect his opinion, he should refer the matter to the proper representatives of the client with the recommendation that it be pursued to a conclusion. For example, frauds involving "lapping" accounts receivable collections, or frauds involving overstatements of inventory, could be material, while those involving peculations from a small imprest fund would normally be of little significance because the operation and size of the fund tends to establish a limitation.

8. The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part. He is not an insurer or guarantor; if his examination was made with due professional skill and care in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking.

Responsibility to the Profession

9. The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the Institute has adopted, as part of its Code of Professional Ethics, rules which support the standards and provide a basis for enforcement of them.

Filings Under Federal Securities Statutes

10. As in the case of financial statements used for other purposes, management has the responsibility for the financial

representations contained in documents filed under the federal securities statutes. In this connection the Securities and Exchange Commission has said: "The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon the accounting" (4 SEC 721[1939]).

11. The responsibility of the independent auditor resulting from the inclusion of his report in registration statements, proxy statements, and periodic reports filed under the federal securities statutes is in substance no different from that involved in other types of reporting as previously described. However, the nature and extent of this responsibility are specified in some detail in these statutes and in the rules and regulations issued thereunder. For example, the Securities Act of 1933, as amended, in Section 11(a) imposes responsibility for false or misleading statements, or for omissions which render misleading the statements made, in an effective registration statement on

> ... every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; ...

12. However Section 11(b) provides that no person, other than the issuer of the security, shall be liable under the above provision who shall sustain the burden of proof that

> ... as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (1) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a

> material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; . . .

13. The discussion in this booklet of the responsibilities of the independent auditor in connection with filings under the federal securities statutes is not intended to offer legal interpretations, and is based on an understanding of the meaning of the statutes as they relate to accounting principles and auditing standards and procedures. The discussion is subject to any judicial interpretations which may issue in the course of time.

14. Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent auditor whose report is included in such a registration statement has a statutory responsibility which is determined in the light of the circumstances on that date. This aspect of responsibility is peculiar to reports used for this purpose. See chapter 11, page 78, "Reporting on Subsequent Events" for further discussion of this matter.

15. The other federal securities statutes, while not containing so detailed an exposition, do impose responsibility, under certain conditions, on persons making false or misleading statements with respect to any material fact in applications, reports or other documents filed pursuant to the statute.

16. In filings under the Securities Act of 1933, frequently a statement is made in the prospectus that certain information is included in the registration statement in reliance upon the report of certain named experts. The independent auditor should make sure that his name is not being used in such a way as to indicate that his responsibility is greater than he intends. The "experts section" should be so worded that there is no implication that the financial statements have been prepared by the independent auditor or that they are not the direct representations of management. Another section of the typical prospectus which the independent auditor should carefully review is the introduction to the summary of earnings or statement of income in the forepart of the prospectus.

CHAPTER 2

Generally Accepted Auditing Standards

1. Auditing standards differ from auditing procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as thus distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with the judgment exercised by him in the performance of his examination and in his report.

2. The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

3. Each of the standards is discussed separately in the following chapters.

4. These standards to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another. The elements of "materiality" and "relative risk" underlie the application of all the standards, particularly the standards of field work and reporting.

5. The concept of materiality is inherent in the work of the independent auditor. There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material error are greater than with respect to those of lesser importance or those in which the possibility of material error is remote. For example, in an enterprise with few, but large, accounts receivable, the accounts individually are more important, and the possibility of material error is greater than in another enterprise that has a great number of small accounts aggregating the same total. In industrial and merchandising enterprises, inventories are usually of great importance to both financial position and results of operations and accordingly may require relatively more attention by the auditor than would the inventories of a public utility company. Similarly, accounts receivable usually will receive more attention than prepaid insurance.

6. The degree of risk involved also has an important bearing on the nature of the examination. Cash transactions are more susceptible to irregularities than inventories, and the work undertaken on cash may therefore have to be carried out in a more conclusive manner, without, however, necessarily implying a greater expenditure of time. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed. The effect of internal control on the scope of an examination is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error; i.e., the stronger the internal control, the less the degree of risk.

CHAPTER 3

The General Standards

1. The general standards, as previously noted, are personal in nature and are concerned with the qualifications of the auditor and the quality of his work as distinct from those standards which relate to the performance of his field work and to his reporting. These personal, or general, standards apply alike to the areas of field work and reporting. The general standards are as follows:

> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
> 2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Training and Proficiency of the Independent Auditor

2. The first general standard recognizes that however capable a man may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.

3. In the performance of the examination which leads up to

an opinion the independent auditor holds himself out as one who is proficient in accounting practice and auditing procedure. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional man. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

4. The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes conjointly in determining the extent of his supervision of his subordinates and his review of their work. It should be recognized that the training of a professional man includes a continual awareness of new developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accouting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.

5. In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or other-

wise disclosed by his examination. As a result, his opinion provides reasonable assurance that a fair presentation of pertinent information has been made in the financial statements.

Independence

6. The second general standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor, but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners (shareholders) of a business, but also to creditors and those who may otherwise rely (in part, at least) upon the auditor's report, as in the case of prospective owners or creditors.

7. It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

8. The profession has established through the Institute's Code

of Professional Ethics precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code of ethics, they have the force of professional law for the independent auditor.

9. The Securities and Exchange Commission has likewise emphasized the importance of independence by adopting similar rules.

10. The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.

11. To emphasize independence from management many corporations follow the practice of having the independent auditor appointed by the board of directors or elected by the stockholders.

Due Care in the Performance of Work

12. The third general standard requires the independent auditor to perform his work with due care. Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination.

13. A paragraph appearing in *Cooley On Torts* often cited by attorneys in discussing due care merits quotation here:

> Every man who offers his service to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is prerequisite, if one offers his service, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or un-

skilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.

14. The matter of due care concerns what the independent auditor does and how well he does it. For example, due care in the matter of working papers requires that their content be sufficient to support the auditor's opinion and his representation as to compliance with auditing standards.

CHAPTER 4

Adequacy of Planning and the Timing of Field Work

1. The first standard of field work reads:

> The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. Some aspects of the independent auditor's responsibility for supervising his assistants have been discussed in chapter 3. Planning of the field work and the timing of auditing procedures are discussed here.

Appointment of the Independent Auditor

3. Consideration of the first standard of field work recognizes that early appointment of the independent auditor has many advantages to both the auditor and his client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. Preliminary work by the auditor benefits the client in that it permits the examination to be performed in a more efficient manner and to be completed at an early date after the year end. The performance of some of the audit work during the year likewise permits early consideration of accounting problems affecting the financial statements and early modification of accounting procedures that the auditor thinks might be improved.

4. Early appointment is particularly helpful with respect to planning for the observation of the taking of physical inven-

tories. The spreading of work through the year also permits more efficient scheduling of staff assignments with a resultant minimum of overtime and, accordingly, improved staff morale.

Timing of Audit Work

5. Many audit tests can be conducted at almost any time during the year. In the course of interim work, the independent auditor makes tests of the client's records, procedures and representations to determine the extent to which he may rely on them. His conclusions assist him to determine the audit procedures to be undertaken to complete the examination. It is acceptable practice for the auditor to carry out substantial parts of the examination at interim dates.

6. When a significant part of the examination is carried out during the year and internal control is found to be effective, year-end audit procedures may consist mainly of comparisons of year-end balances with balances at prior dates, and review and investigation of unusual transactions and significant fluctuations. The auditor must satisfy himself, however, that the internal control procedures are still effective at the year end. This does not mean that he must again test the records and transactions unless his inquiries and observations lead him to believe that conditions have changed significantly.

7. Tests of procedures are particularly appropriate in the examination of accounts representing a great number of transactions. Examination of accounts which represent an accumulation of a relatively few transactions, on the other hand, may place more emphasis on substantiation of account balances than on tests of procedures.

Timeliness and Orderliness

8. The first standard of field work concerns particularly the timeliness of the auditing procedures and the orderliness of their application.

9. The timeliness with which auditing procedures are undertaken involves the proper timing and synchronizing of their

application and thus comprehends the possible need for simultaneous examination of, for example, cash on hand and in banks, securities owned, bank loans, and other related items. It may also require an element of surprise, establishment of audit control over assets readily negotiable, and establishment of a proper cutoff at a date other than the balance-sheet date. All of these matters are to be resolved in the light of the effectiveness of internal control in a particular situation.

10. The need for orderliness in carrying out audit procedures is apparent, for example, in the application of procedures for inventory observation. Review of proposed inventory count procedures, as planned by the client, is as essential for this purpose as is the review of the client's procedures for establishing a proper cutoff of sales and purchases in the books of account. Another example is found in the examination of negotiable securities. When the negotiable securities are of considerable volume, planning may be necessary to guard against the substitution of securities already counted for other securities which should be on hand but are not.

Appointment of Auditor Near or After the Year-End Date

11. Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate examination and expression of an unqualified opinion and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion. Sometimes the audit limitations present in such circumstances can be remedied. For example, the taking of the physical inventory can be postponed or another physical inventory can be taken which the auditor can observe.

Examination of Interim Financial Statements

12. Generally accepted auditing standards applicable to examinations of annual financial statements are also applicable to ex-

aminations of interim financial statements. A problem may be presented, however, where examinations of the usual scope are made at interim dates in accordance with generally accepted auditing standards except that the observation of inventories and the confirmation of receivables are not repeated for each interim period. In such instances, the auditor will have to consider whether conditions are such as to enable him to express an opinion with respect to the interim statements.

13. Frequently the conditions surrounding a particular engagement may warrant, or even make desirable, the staggering of receivable confirmations and physical-inventory observations throughout the year. If this is done with adequate consideration of the effectiveness of internal control, no exception as to scope of the interim examination respecting confirmation of receivables and observation of inventory taking is required in the independent auditor's report.

14. When customary audit procedures for receivables and inventories are performed as of a date either before or after that of the interim financial statements, but within a time considered to be reasonable in view of the effectiveness of the internal control and the adequacy of the records supporting the interim changes, again no exception as to the scope is necessary.

CHAPTER 5

Evaluation of Internal Control

1. The second standard of field work reads:

> There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

2. Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.

3. There is no conflict between the auditor's responsibility to evaluate internal control as stated above and the statements in chapter 1 relating to the responsibilities and functions of the independent auditor to the effect that the ordinary examination incident to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result.

Elements of a Properly Co-ordinated System

4. A well-developed system of internal control might include budgetary control, standard costs, periodic operating reports,

statistical analyses, a personnel training program, and an internal audit staff. It might properly comprehend activities in other fields as, for example, time and motion studies of an engineering nature and quality controls through inspection which are a production function.

5. In the broad sense, internal control includes, therefore, controls which may be characterized as either accounting or administrative, as follows:

a. *Accounting controls* comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

b. *Administrative controls* comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

The extent to which particular organizational plans and control methods and procedures may be classified as accounting controls or administrative controls will, of course, vary in individual circumstances.

6. The characteristics of a satisfactory system of internal control would include:

a. A plan of organization which provides appropriate segregation of functional responsibilities,

b. A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses,

c. Sound practices to be followed in performance of duties and functions of each of the organizational departments, and

d. Personnel of a quality commensurate with responsibilities.

7. These elements, as important as each is in its own right, are all so basic to adequate internal control that serious deficiencies in any one normally would preclude successful operation of the system. For example, no system of authorization and record procedures for accounting control may be considered adequate without personnel capable of performing the procedures designed to make such a system work. While each element is discussed separately in the following sections, the interrelationship of all elements must be borne in mind.

Plan of Organization

8. Although the appropriate plan of organization will vary with the enterprise, generally a satisfactory plan should be simple and flexible and should lend itself to the establishment of clear lines of authority and responsibility.

9. An important element in any plan of organization is the organizational independence of the operating, custodial, accounting and internal auditing functions. Organizational independence requires separation of duties in such a way that records existing outside each department serve as controls over the activities within the department. Although organizational independence requires this separation, the work of all departments must be integrated and co-ordinated to provide for the smooth flow of work and over-all efficiency of operation.

10. In addition to a proper functional division of duties, responsibility within the divisions must be established in conformity with managerial policy requirements. With responsibility must go the delegation of authority to meet such responsibilities. Responsibilities and the attendant delegation of authority should be clearly defined and set forth in organizational charts or manuals. Conflicting and dual responsibilities should be avoided,

but where the work of two or more divisions is complementary, the responsibility for phases may be divided.

11. Such divisions of responsibility are inherent in good internal control, which provides that the functions of initiation and authorization of an activity should be separate from the accounting for it. Similarly, custody of assets should be separate from the accounting for them.

System of Authorization and Record Procedures

12. A satisfactory system must include media; first, for the records control of the operations and transactions (source data and its flow) and, second, for the classification of data within a formal structure of accounts (a chart of accounts). A carefully prepared chart of accounts facilitates preparation of financial statements. If the chart of accounts is supplemented by an account manual which clearly defines the accounts and the entries to be made therein, greater uniformity can be achieved in recording accounting transactions.

13. Media for the original records control of the operations and transactions are created through the designing of appropriate records and forms and through planning the logical flow of the record-keeping and approval procedures. Such forms, and the instructions regarding the flow of recording and approval procedures, are often incorporated in procedure manuals.

Sound Practices

14. The soundness of the practices followed in the performance of the duties and functions of each of the organizational departments will largely determine the effectiveness of the internal control and the resultant efficiency in operations. The procedures adopted should provide the steps required for authorizing transactions, recording them and maintaining custody of the assets. Sound practices should provide the means for assuring the integrity of such authorizations, recordings and custody. This is usually accomplished by a division of duties and responsibilities so that no one person will handle a transaction

completely from beginning to end. By such a division, an ancillary check on the accuracy of the work is provided and the probability of detecting errors or fraud promptly is enhanced. As explained under "Plan of Organization," page 29, this division of responsibility applies to departments, as well as to individuals, and should carry through the entire organization at all levels of authority.

Personnel

15. A properly functioning system of internal control depends not only on effective organization planning and the adequacy of the procedures and practices, but also on the competence of officers, department heads and other key employees to carry out prescribed procedures in an efficient and economical manner.

Internal Control and Management

16. Management has the responsibility for devising, installing and supervising an adequate system of internal control. Any system, regardless of its fundamental soundness, may deteriorate if not reviewed periodically. The system of internal control must be under continuing supervision to determine whether (1) prescribed policies are being interpreted properly and are being carried out, (2) changes in operating conditions have made the procedures cumbersome, obsolete or inadequate, and (3) effective corrective measures are taken promptly where breakdowns in the system appear. An internal audit staff is a strong factor in a system of internal control, since it provides a means of surveying the effectiveness of and adherence to the prescribed procedures.

Internal Control and the Independent Auditor

17. While the responsibility for the establishment and enforcement of internal control rests with management, the degree to which such controls exist and are carried out is of great concern to the independent auditor.

18. A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records. The independent auditor's review of the system of internal control assists him in determining other auditing procedures appropriate to the formulation of an opinion on the fairness of the financial statements.

19. Adequate evaluation of a system of internal control requires knowledge and understanding of the procedures and methods prescribed and a reasonable degree of assurance that they are in use and are operating as planned. The degree of reliance which may be placed on internal control in determining the extent of the tests to which auditing procedures are to be restricted cannot be fully determined at the beginning of an audit engagement, as it may be predicated upon assumptions with regard to the system which the independent auditor's later tests may show not to be as represented to him. A revision of his audit program may be necessary if the later tests do not support the initial assumptions. The revision may be either an extension of audit tests or the shifting of emphasis or timing of the audit procedures.

20. The work of an internal auditor should be considered by the independent auditor as a supplement to, not as a substitute for, the work of the independent auditor. He should survey the activities of the internal audit staff, where one exists, to determine their effect on his selection of appropriate audit procedures and the required extent of tests.

21. The independent auditor is primarily concerned with the accounting controls. Accounting controls, as previously described, generally bear directly and importantly on the reliability of financial records and require evaluation by the auditor. Administrative controls, also previously described, ordinarily relate only indirectly to the financial records and thus would not require evaluation. If the independent auditor believes, however, that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the the need for evaluating such controls. For example, statistical

records maintained by production, sales or other operating departments may require evaluation in a particular instance.

22. Where feasible, the independent auditor's review of internal control may be conducted as a separate phase of the examination, preferably at an interim date, by applying appropriate auditing procedures directed particularly to appraising the effectiveness of the client's system. Where this is not feasible, the review will usually be made in conjunction with other phases of the audit program. A record of the independent auditor's review should be prepared in some suitable form.

23. As a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

CHAPTER 6

Evidential Matter

1. The third standard of field work reads:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

2. Most of the independent auditor's work in formulating his opinion on financial statements consists of obtaining and examining evidential matter. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Evidential Matter

3. Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor.

4. The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in sup-

port of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted.

5. Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning.

6. The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is an internal integrity and interrelationship discoverable through such procedures that constitutes persuasive evidence that the financial statements do present fairly financial position and results of operations.

7. The pertinent documentary material to support entries in the accounts and representations in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions as he observes them, conditions of internal control for example, he can reason to conclusions with respect to the validity of various representations in the financial statements.

Competence of Evidential Matter

8. To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circum-

stances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

a. When evidential matter can be obtained from independent sources outside an enterprise it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the enterprise.

b. When accounting data and financial statements are developed under satisfactory conditions of internal control there is more assurance as to their reliability than when they are developed under unsatisfactory conditions of internal control.

c. Direct personal knowledge of the independent auditor obtained through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

Sufficiency of Evidential Matter

9. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In making such decisions, he should consider the nature of the item under examination; the materiality of possible errors and irregularities; the degree of risk involved, which is dependent on the adequacy of the internal control and the susceptibility of the given item to conversion, manipulation, or misstatement; and the kinds and competence of evidential matter available.

10. The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion under the circumstances. In the great majority of cases, the auditor finds it necessary to rely on

evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the over-all proposition that the financial statements as a whole present fairly the financial position and results of operations of the reporting company are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.

11. To the extent the auditor remains in substantial doubt as to any assertion of material significance, he must refrain from formulating an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.

12. An auditor typically works within economic limits; his opinion, to be economically useful, must be formulated within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify formulation and expression of an opinion.

13. As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. In determining the usefulness of evidence, relative risk may properly be given consideration. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test.

14. In determining the extent of a particular audit test and the method of selecting items to be examined, the auditor might consider using statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available.

15. In selecting procedures to obtain competent evidential matter, the independent auditor should recognize the possibility that the financial statements may not be presented fairly. In developing his opinion the auditor must give consideration to relevant evidential matter whether it appears to support or to con-

tradict the representations made in the financial statements. Thus it is not sufficient to offer an opinion only on the grounds that nothing came to the auditor's attention to cause him to question the assertions in the financial statements under examination. The auditor should be thorough in his search for evidential matter and objective in its evaluation.

Receivables and Inventories

16. By vote of the Institute's membership in 1939, confirmation of receivables and observation of inventories were established as generally accepted auditing procedures, where they are practicable and reasonable and the assets concerned are material to financial position or results of operations. The procedures must be both practicable and reasonable. In auditing, practicable means "capable of being done with the available means" or "with reason or prudence"; reasonable means "sensible in the light of the surrounding circumstances."

17. In the rare situation in which these procedures are practicable and reasonable and are not used, and other procedures can be and are employed, the independent auditor must bear in mind that he has the burden of justifying the opinion expressed.

18. Confirmation of receivables requires direct communication with debtors; the method and time of requesting such confirmations and the number to be requested are determined by the auditor. Such matters as the degree of internal control to which accounts receivable are subject, the apparent possibility of disputes, inaccuracies, or irregularities in the accounts, the probability that requests will fail to receive consideration, and the materiality of the amounts involved are factors to be considered by the auditor in selecting the method, extent, and timing of his confirmation procedures.

19. Where inventory quantities are determined solely by means of a physical count, and all counts are made as of a single date, it is ordinarily necessary for the auditor to be present at the time of count and, by suitable observation and inquiry, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon

the client's representations about inventories and upon the records thereof. In so doing he may require physical tests of inventories to be made under his observation. Where well-kept perpetual inventory records are checked periodically by physical count and comparisons, the independent auditor's procedures can usually be performed at any interim date or dates selected by him.

20. The planning and timing of audit procedures and the appropriate application of the fourth reporting standard in circumstances where receivables are not confirmed and the inventory-takings are not observed are discussed in chapters 4 and 10.

CHAPTER 7

Adherence to Generally Accepted Accounting Principles

1. The first standard of reporting reads:

> The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The term "principles of accounting" as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed to require not a statement of fact by the auditor, but an opinion as to whether the financial statements are presented in conformity with such principles. If limitations on the scope of the auditor's examination make it impossible for him to form an opinion as to such conformity, appropriate qualification of his report is required.

3. The determination of whether financial statements are presented in accordance with "generally accepted accounting principles" requires exercise of judgment as to whether the principles employed in the statements have found general acceptance. The determination further requires a familiarity with alternative principles, sometimes more than one, which may be applicable to the transaction or facts under consideration, and a realization

that an accounting principle may have only limited usage but still have general acceptance.

4. Generally accepted accounting principles evolve and change. Pronouncements issued by authoritative bodies of the American Institute of Certified Public Accountants give recognition to such changes. The first reporting standard contemplates that the independent auditor will be alert to such pronouncements. He must also be alert to changes which become acceptable through common usage by business although not a subject of an Institute pronouncement.

5. Reference should be made to chapters 8, 10, and 13 which contain further comments on the application of this standard.

CHAPTER 8

Consistency of Application of Generally Accepted Accounting Principles

1. The second standard of reporting reads:

> The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

2. The term "current period" means the most recent year or period of less than one year upon which the independent auditor is reporting. It is implicit in the standard that such principles have been consistently observed within each period. As noted in chapter 7, the term "principles of accounting" as used in the reporting standards is construed to include not only accounting principles and practices, but also the methods of applying them.

3. The objective of the consistency standard is: (1) to give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application; or (2) if comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

Comparability of Financial Statements

4. Proper application of the consistency standard requires a clear understanding by the independent auditor of the relationship of consistency to comparability. The consistency standard involves the consistent application of accounting prin-

ciples; lack of consistency produces lack of comparability. However, lack of comparability may be caused by other factors unrelated to consistency and even unrelated to accounting.

5. In general, comparability of financial statements as between years is affected by changes arising from: (a) a change in accounting principles employed, (b) changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed, and (c) changed conditions unrelated to accounting.

6. Only the first of these three classes involves the consistency standard and therefore only changes of this class having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Changes of the second and third classes having a material effect on the financial statements will not ordinarily be commented upon in the independent auditor's report. However, fair presentation may require their disclosure in the notes to the financial statements. Distinguishing characteristics of the types of changes included in each of these three classes are more fully described and commented upon in the following paragraphs.

A. Comparability of financial statements affected by a change in accounting principles employed.

7. A characteristic of this type of change is that it involves a choice by management from among two or more accounting principles. The reason for the change need not be stated. Examples are a change from the straight-line method to the declining-balance method of depreciation, and a change from the pay-as-you-go basis to the accrual basis of accounting (whether or not funded) for an existing pension commitment or plan.

8. This type of change is intended to be covered by the consistency standard and should be recognized in the independent auditor's opinion.

B. Comparability of financial statements affected by changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed

9. A characteristic of this type of change is that it is an accounting change required by altered conditions (rather than by the consummation of a business transaction). It involves no choice by management since the accounting principles employed have not changed; hence, although comparability may be affected, consistency is not involved. Examples are a change in the estimated remaining useful life of plant property arising from operating experience or obsolescence, and a changed provision for pension plan accruals arising from revisions in actuarial assumptions based upon experience of the plan.

10. A change of this type having a material effect on the financial statements should be disclosed in a note to the financial statements. It would not ordinarily be commented upon in the independent auditor's report* since it would not affect his opinion as to consistency. If commented upon in his report, it would be as a disclosure matter under the third standard of reporting.

C. Comparability of financial statements affected by changed conditions unrelated to accounting

11. A characteristic of this type of change is that it results from some specific happening or transaction which has accounting effect, as do most business transactions, but which does not involve a change in any accounting principle employed. As a result, an accounting principle may be employed for the first time; this is not a "change" in accounting principles and therefore does not require comment as to consistency in the independent auditor's opinion. Examples are the acquisition or disposition of a subsidiary or plant, and the original adoption of a pension plan.

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*With respect to financial statements filed with the Securities and Exchange Commission, Regulation S-X requires the independent auditor to disclose in his report, and express his opinion of any material changes in accounting principles or practices or methods of applying them which affect *comparability*, or any material retroactive adjustments of the accounts, as described in the applicable rules. With respect to a type B change described above, these requirements may be met by the use of a middle paragraph which describes the change and expresses the independent auditor's view thereon; when this is done the change should not be referred to in the opinion paragraph since the consistency standard is not involved.

12. Only in unusual circumstances would this type of change be commented upon in the independent auditor's report, although fair presentation may require disclosure in the notes to the financial statements; if commented upon in the independent auditor's report it would be as a disclosure matter and not as a consistency matter.

Reclassifications

13. Although reclassifications of items in the financial statements may result in lack of comparability, they are usually not of sufficient importance to necessitate any disclosure. However, material changes in classification should be indicated and explained in the financial statements or notes; if appropriately disclosed, such changes ordinarily need not be referred to in the independent auditor's report.

Period to Which the Consistency Standard Relates

14. The consistency standard is aimed at comparability of the financial statements of the current year with those of the preceding year (whether presented or not) and at comparability of all financial statements presented in comparative form. When the independent auditor's opinion covers the statements of two or more years, there is generally no need to disclose an inconsistency with a year prior to the years for which statements are being presented. Accordingly, the phrase "on a basis consistent with that of the preceding year" is ordinarily inapplicable whenever the opinion covers two or more years. Instead, language similar to "consistently applied during the period" or "applied on a consistent basis" should be used.

Reporting on Inconsistency

15. When a change has been made in the accounting principles employed during the year or years the independent auditor is reporting upon (type A referred to on page 43) and the change has a material effect upon financial position or

results of operations, he should refer in his opinion paragraph to a note to the financial statements which adequately describes the change and its effect, or describe adequately in his report the nature of the change and its effect. Where the change affects net income, the disclosure should include the amount by which net income is affected after consideration of related income taxes.

16. Ordinarily, the disclosure would give the amount by which the current year's net income was affected as a result of the change; however, there may be instances where the effect the change would have had on the prior year's net income would be considered an appropriate disclosure.

17. Although the independent auditor's advice is frequently sought and followed, management has the responsibility for the selection of the appropriate accounting principles to be employed in its financial statements. The expression of the independent auditor's opinion of changes affecting consistency will vary with the circumstances, as explained in the following paragraphs 18-20.

Change to an Alternative Generally Accepted Accounting Principle

18. When the client makes a change from the use of one generally accepted accounting principle, practice or method of application to another which is generally accepted, the independent auditor need not indicate whether he approves or accepts the change. Although reference to the change is required in his opinion, the absence of qualification regarding fair presentation in conformity with generally accepted accounting principles is sufficient to indicate that the independent auditor considers the newly adopted accounting principle to be generally accepted. However, if he wishes, the independent auditor may express his approval of the change in his report (see footnote, p. 44). An illustration of expression of approval follows:

> . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the change, (insert expression of approval), in pricing

of inventories . . . as described in Note___ to the financial statements.

(NOTE: Some expressions of approval are "which we approve," "in which we concur," "to an accepted alternative method," and "to which we do not object." The use of these expressions is optional.)

Change From a Principle or Practice Which Lacks General Acceptance to a Generally Accepted Accounting Principle

19. Ordinarily, the independent auditor will want to express his approval of a change from a principle or practice which lacks general acceptance to a generally accepted accounting principle. In these instances the illustration above and on pages 49 and 50 are considered appropriate.

Change to a Principle or Practice Which Lacks General Acceptance

20. Where the effect of a change to a principle or practice which is not generally accepted is material, the independent auditor should so state in his report. Such statement requires either a qualification of his opinion as to fair presentation in conformity with generally accepted accounting principles or, if the change is *sufficiently* material, an adverse opinion on the financial statements taken as a whole.

Illustrations follow:

Qualified Opinion

(Opinion paragraph)

In our opinion, except for (brief description of the change and its effect) as explained in Note___, a practice which we believe is at variance with generally accepted accounting principles, the accompanying statements present fairly the financial position of X Company at October 31, 19___, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Middle paragraph)
The company has heretofore followed the practice of (brief description of prior practice) and has now adopted the practice of (brief description of new practice). As a result of this change, reported net income for the year ended October 31, 19__, and retained earnings as of that date, are each $________ greater than they otherwise would have been.

(Opinion paragraph)
In view of the materiality of the effect of the above noted change to a practice which we believe is at variance with generally accepted accounting principles, we are of the opinion that the financial statements do not present fairly the financial position of X Company at October 31, 19__, or the results of operations for the year then ended, in conformity with generally accepted accounting principles.

(NOTE: Since the independent auditor completed his examination in accordance with generally accepted auditing standards, and *has* an opinion (adverse) on the statements, he should not *disclaim* an opinion.)

Changes expected to have a Material Future Effect

21. If a change is made in the accounting principles employed which has no material effect on the financial statements in the current year, but which is reasonably certain to have substantial effect in later years, it should be appropriately disclosed in a note to the financial statements for the year in which the change is adopted by the client. An example of such a note follows:

It has been the consistent practice of the company to provide for the depreciation of properties on a straight-line basis over their estimated useful lives. Commencing with the current year, the company is providing for depreciation on new additions to property on the declining-balance method. This change has no material effect on the current financial statements.

22. If such a change is appropriately disclosed in a note to the financial statements as indicated above, it need not be mentioned in the independent auditor's report. However, if such a

change is not set forth in a note to the financial statements, it should be disclosed by the independent auditor in his report.

Restated Amounts in Financial Statements of Prior Years

23. When a change has been made in the accounting principles employed and the accounts have been adjusted retroactively, it is desirable to restate financial information which is presented for any prior year, or years, affected. Such a restatement places all the periods being compared on the same basis with respect to the use and application of accounting principles.

24. In such cases, the independent auditor may report only on the current year, or he may report on all the years which have been restated, as well as on the current year. In either case, disclosure of the change should be made in the financial statements or the notes with an indication of its effect on the year or years restated in the comparative financial statements.

25. When he reports only on the current year, a change in that year should be referred to in his opinion somewhat as follows:

> . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year after giving retroactive effect to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note___ to the financial statements.
>
> (NOTE: The use of "which we approve" is optional, see footnote p. 44.)

26. When the independent auditor reports on all the years which have been restated as well as on the current year, he may be giving a new opinion with respect to the earlier years. Even though all years covered by his report are on a consistent basis, and the changes made are adequately disclosed in the financial statements and notes, his report should make reference to the restatement in the year of change. If such reference is made in the opinion paragraph, it may read somewhat as follows:

> . . . applied on a consistent basis after giving retroactive effect

to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note__ to the financial statements.

(NOTE: The use of "which we approve" is optional, see footnote, p. 44.)

27. If the change took place in other than the current year and prior years have been restated, no reference to the change is necessary in the independent auditor's report. However, disclosure of the change should be made in the financial statements or notes relating to any prior year restated in comparative financial statements.

Financial Statements of Prior Years Not Restated

28. When financial statements are presented in comparative form and prior years are not restated to give effect to a change in the accounting principles employed, adequate disclosure requires a description of the nature and effect of the change.

29. When the change took place in the current year, it should be disclosed in the independent auditor's report as explained in paragraph 34, page 51.

30. When the change took place in other than the current year and the independent auditor:

(a) Is reporting on all the years, he should refer in the opinion paragraph of his report to a note to the financial statements which adequately describes the change and its effect, or make such disclosure in his report;

(b) Is reporting only on the current year, no reference is necessary in his report but disclosure of the change should be made in an appropriate note to the financial statements.

The Independent Auditor's First Report

31. When the independent auditor reports on the first accounting period of a newly organized company, he need make no reference to consistency, since there exists no previous period with which to make a comparison.

32. When the independent auditor makes his first examination of an established company, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent as between the current and the preceding year. Where adequate records have been maintained by the client, it is practicable and reasonable to extend auditing procedures sufficiently to give an opinion on consistency. Limitations imposed by the client with respect to these procedures would require appropriate qualification.

33. There may be situations where the inadequacy of the financial records for the earlier years precludes the independent auditor from forming an opinion as to the consistent application of accounting principles and the reasonable accuracy of the account balances at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would be unable to express an opinion on the current year's statement of income. When this is the case the independent auditor should state in his report that the inadequate condition of the records prevents him from expressing an opinion not only on consistency but also on the statements of income and retained earnings for the current year. For example, the independent auditor's report might contain the following:

> . . . and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.
>
> Because of major inadequacies in the company's accounting records for the previous year, it was not practicable to extend our auditing procedures sufficiently to enable us to express an opinion on the statement(s) of income and retained earnings for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.
>
> In our opinion, the accompanying balance sheet presents fairly the financial position of the X Company as of (current year end) in conformity with generally accepted accounting principles.

34. If accounting records for prior years were kept on a basis

which did not result in a fair presentation of financial position and results of operations for those years, comparison of the statements upon which the independent auditor is reporting with those of prior years would be of little significance. Accordingly, the customary reference to consistency in the independent auditor's report may be omitted and his report could be presented as follows:

> (Middle paragraph)
> The company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the company, with our approval, adopted the accrual basis of accounting, and appropriate adjustments, where material, have been made to retained earnings as of the beginning of the year.
>
> (Opinion paragraph)
> In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of the X Company as of October 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles.

Pooling of Interests

35. When companies have been merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of results of operations and earnings per share of years prior to the year of pooling as described in Accounting Research Bulletins No. 48 and 49. Comparative financial statements which do not give appropriate recognition to the pooling are not presented on a consistent basis. The inconsistency arises, in this case, not from a change in the application of an accounting principle in the current year but from the lack of such application to prior years. Accordingly, in order to avoid a misleading inference which might otherwise arise, the independent auditor should refrain from the use of the expression "on a basis consistent with that of the preceding year" whenever comparative statements are presented in which prior years' operating state-

ments of the constituents have not been appropriately combined or shown separately. In such instances he should disclose in his report the lack of consistency and describe, or refer to a note to the financial statements which describes: (1) the nature of the pooling and (2) the effect of the pooling upon results of operations of all prior years presented.

36. When single-year statements only are presented, a note to the financial statements should adequately disclose the pooling transaction and state the net incomes of the constituent companies for the preceding year separately or on a combined basis. Omission of such a disclosure would require appropriate comment in the independent auditor's report. With either type of disclosure, the independent auditor may express the usual opinion on consistency.

CHAPTER 9

Adequacy of Informative Disclosure

1. The third standard of reporting reads:

> Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

2. The fairness of presentation of financial statements, apart from the relationship to generally accepted accounting principles, is dependent upon the adequacy of disclosures involving material matters. These matters relate to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given, the classification of items in the statements; the bases of amounts set forth, for example, with respect to such assets as inventories and plants; liens on assets; dividend arrearages, restrictions on dividends, contingent liabilities; and the existence of affiliated or controlling interests and the nature and volume of transactions with such interests. This enumeration is not intended to be all inclusive, but simply indicative of the nature and type of disclosures necessary to make financial statements sufficiently informative.

3. Verbosity should not be mistaken for adequate disclosure. What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgment in light of the circumstances and facts of which he is aware at that time. That later events may give greater importance to matters

which at the time appeared to be of minor consequence does not, of itself, impugn the soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time; hindsight should be eliminated from the factors by which the soundness of past conclusions are judged.

4. If matters which the independent auditor believes require disclosure are omitted from the financial statements, the matters should be included in his report and he should appropriately qualify his opinion (see chapter 10, page 71).

5. Disclosure should not be considered to require publicizing certain kinds of information that would be detrimental to the company or its stockholders. For example, the threat of a patent infringement suit might impel a conscientious management to set up an ample reserve for possible loss, even though it would expect to fight the issue vigorously. But publicity given to such a loss provision might inure to the harm of the company or its stockholders, for courts have held that a reserve for patent infringement constituted an allocation of infringement profits (where ready determination otherwise was not feasible) notwithstanding a refusal on the part of the company or its management to concede that such an amount might be an equitable allotment of the profits in dispute.

6. Somewhat related to the matter of disclosure is the matter of information which the auditor receives in confidence akin to the status of privileged communication. Without such confidence the auditor might at times find it difficult to obtain information necessary for him in the formulation of his opinion. If the information received, does not in his judgment, require disclosure for the financial statements not to be misleading, this standard does not require disclosure of such information. The matter of disclosure of events occurring subsequent to the balance sheet date is discussed in chapter 11.

CHAPTER 10

Expression of Opinion, or Reasons for no Opinion, in the Independent Auditor's Report

1. The fourth standard of reporting reads:

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

2. The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the independent auditor is assuming whenever his name is associated with financial statements. In considering the degree of responsibility he is assuming, the auditor must bear in mind that justification for the expression of his opinion, whether qualified or unqualified, rests on the degree to which the scope of his examination conforms with generally accepted auditing standards.

3. Although the fourth reporting standard states that "The report shall either contain an expression of opinion regarding the financial statements taken as a whole, or an assertion to the

effect that an opinion cannot be expressed," this standard does not preclude the expression of separate opinions on financial position and results of operations. The independent auditor may express an unqualified opinion on one of the financial statements and disclaim an opinion or express a qualified or an adverse opinion on the others (see page 64).

Short-form Report

4. The short-form report of the auditor is customarily used in connection with the basic financial statements. It is also often included as part of a long-form report. The usual short-form report consists of a representation as to the work performed, expressed in an opening or "scope" paragraph, and a representation as to the independent auditor's conclusions usually in a closing or "opinion" paragraph.

5. Because of the weight which the independent auditor's opinion carries with the investing and lending public and the responsibilities he assumes in expressing it, reasonable uniformity in the manner of stating the opinion is important both to the auditor and to those who rely on his findings.

6. The profession in general has adopted the following short form of independent auditor's report:

> We have examined the balance sheet of X Company as of June 30, 19___ and the related statement(s) of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of X Company at June 30, 19___, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

7. The report should be addressed to the client, or to the board of directors or the stockholders of the client if the ap-

pointment is made by them or if such address is preferred. Where the appointment of the auditor is made by the directors and approved by the stockholders the report may well be addressed to both.

Unqualified Opinion

8. An unqualified opinion that financial statements present fairly financial position and results of operations may be expressed only when the independent auditor has formed the opinion, on the basis of an examination made in accordance with generally accepted auditing standards, that the presentation conforms with generally accepted accounting principles applied on a consistent basis and includes all informative disclosures necessary to make the statements not misleading.

Qualified Opinion

9. When a qualified opinion is intended by the independent auditor, the opinion paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and should give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable. Reference in the opinion paragraph to a note to the financial statements or to a preceding paragraph in the report that describes the circumstances is an acceptable method of clarifying the nature of a qualification. However, a qualification based upon the scope of the examination ordinarily should be covered entirely in the independent auditor's report. When a qualification is so material as to negative an expression of opinion as to the fairness of the financial statements as a whole, either a disclaimer of opinion or an adverse opinion is required.

10. The use of phrases that include either "except" or "exception" in qualified opinions on financial statements is recommended. However, in certain cases where the outcome of a matter is uncertain the phrase "subject to" may be appropriate (see

pages 72, 73). Phrases such as "with the foregoing explanation" are generally not clear or forceful enough for a qualification and should not be used to qualify an opinion.

11. Any modifying phrases in the standard short-form opinion paragraph (or sentence) should be considered as qualifying the opinion in some manner; however, reference to the report of other independent auditors as the basis, in part, of the opinion, whether made in the scope paragraph or the opinion paragraph, is not to be construed as a qualification of the opinion on the fairness of presentation of the consolidated financial statements or consistency, but rather as an indication of the divided responsibility for the performance of the work (see pages 66-69).

Adverse Opinion

12. An adverse opinion is an opinion that the financial statements *do not* present fairly the financial position or results of operations in conformity with generally accepted accounting principles.

13. An adverse opinion is required in any report where the exceptions as to fairness of presentation are so material that in the independent auditor's judgment a qualified opinion is not justified. In such circumstances a disclaimer of opinion is *not* considered appropriate since the independent auditor has sufficient information to form an opinion that the financial statements are not fairly presented. Whenever the independent auditor issues an adverse opinion, he should disclose *all* the substantive reasons therefor, usually by referring to a middle paragraph of his report describing the circumstances (see pages 69, 70).

Disclaimer of Opinion

14. When he has not obtained sufficient competent evidential matter to form an opinion on the fairness of presentation of the financial statements as a whole, the independent auditor should state in his report that he is unable to express an opinion on such statements. The necessity of disclaiming an opinion may arise either from a serious limitation on the scope of examination or from the existence of unusual uncertainties concerning the

amount of an item or the outcome of a matter materially affecting financial position or results of operations, causing the independent auditor not to be able to form an opinion on the financial statements as a whole.

15. With respect to significant scope limitations, he may recite the procedures followed (in which case the standard short-form scope paragraph should not be used) or the procedures omitted. In either case, he should state clearly that the scope of examination was not adequate to warrant the expression of an opinion on the financial statements taken as a whole.

16. Whenever the independent auditor disclaims an opinion, he should give *all* substantive reasons for doing so. For example, when he disclaims an opinion because the scope of examination was inadequate, he should also disclose any reservations or exceptions he may have regarding fairness of presentation.

Unaudited Statements

17. When no audit has been performed, or the auditing procedures performed are insignificant in the circumstances, any financial statements with which the independent auditor is in any way associated should be clearly and conspicuously marked on each page as unaudited, whether accompanied by his comments or not. It is preferable that a disclaimer of opinion accompany all such statements; when they are accompanied by comments the independent auditor *must* issue a disclaimer of opinion. Such a disclaimer of opinion may read as follows:

> The accompanying balance sheet as of November 30, 19__ and the related statements of income and retained earnings for the year then ended were not audited by us and we express no opinion on them.

Phrases which may cause the reader to believe an examination or review of any type was made should be avoided in any such disclaimer.

18. The independent auditor should refuse to be associated in any way with unaudited financial statements which he believes are false or misleading (see Opinion No. 8 of the committee on professional ethics).

Negative Assurance

19. Where the scope of the examination is limited by the omission of necessary auditing procedures, reports should not be issued which temper the qualification or disclaimer of opinion by the inclusion of expressions similar to "... However, nothing came to our attention which would indicate that these amounts (statements) are not fairly presented (stated)."

20. However, negative assurances are permissible in letters required by security underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission. These letters usually state specifically that no audit has been made of such statements and data, and distribution of the letters is restricted to parties to the underwriting agreement.

21. In situations involving special reports covering data which do not purport to present financial position or results of operations, negative assurances may be given provided the auditing procedures followed are appropriate and reasonable in the circumstances and the scope of the examination is described in the report (see chapter 13 on Special Reports, p. 87).

Piecemeal Opinions

22. In some situations requiring a disclaimer of opinion or adverse opinion on the over-all fairness of the financial statements, the auditor may, to the extent that the scope of his examination and the findings thereof justify, express a so-called "piecemeal" opinion as to the compliance of the statements with generally accepted accounting principles in respects other than those which require the disclaimer of opinion or adverse opinion. Similarly, in some cases of extensive exceptions, where an over-all opinion has been disclaimed, it may be possible to express an opinion limited to the items in the financial statements with which the auditor is satisfied. When that is done, however, the report must make clear that no over-all opinion as to financial position or operating results is intended and the auditor should

be careful to indicate clearly the limitation of such comments to the individual items in the financial statements.

23. The independent auditor may issue a piecemeal opinion only when, in his judgment, the scope of his examination and his findings justify it, and then only if it is accompanied by a disclaimer of opinion or adverse opinion with respect to the financial statement(s) taken as a whole. Moreover, the piecemeal opinion should not overshadow or appear to contradict the disclaimer of opinion or adverse opinion; otherwise it may result in a misleading inference regarding the financial statements taken as a whole.

24. The auditor, as noted above, in expressing a piecemeal opinion may name the accounts covered by the opinion, or may name those accounts which are excluded and designate the accounts which are covered with an expression such as "all the other accounts." The interrelationship of the accounts affected should be carefully considered by the auditor if the latter approach is used. For example, when an opinion is disclaimed because the taking of the closing inventory has not been observed, it would ordinarily be improper for the independent auditor to use the expression "all the other accounts," thereby covering in his piecemeal opinion cost of sales, gross profit, profit before taxes, taxes, net profit, accrued income taxes, retained earnings, and, perhaps, accounts payable. In any case, a clear description of those aspects of the statement that are covered by the piecemeal opinion is required.

25. The auditor should realize that the expression of a piecemeal opinion with respect to individual items included in a financial statement may require a more extensive examination of such items than would be required if he were expressing an opinion on the financial statements taken as a whole.

Circumstances which Require a departure From the Standard Short-form Report

26. The usual circumstances which may require the independent auditor to deviate from the standard short-form report on financial statements are as follows:

A. The scope of his examination is limited or affected:
   (1) By conditions which preclude the application of auditing procedures considered necessary in the circumstances
   (2) By restrictions imposed by clients
   (3) Because part of the examination has been made by other independent auditors

B. The financial statements do not present fairly financial position or results of operations because of:
   (1) Lack of conformity with generally accepted accounting principles
   (2) Inadequate disclosure

C. Accounting principles are not consistently applied.

D. Unusual uncertainties exist concerning future developments, the effects of which cannot be reasonably estimated or otherwise resolved satisfactorily.

These circumstances are described in greater detail in the following paragraphs of this chapter.

SCOPE OF EXAMINATION

Conditions which Preclude the Application of Necessary Auditing Procedures

27. Circumstances may at times make it impracticable or impossible for the independent auditor to follow certain customary auditing procedures. When this occurs, the independent auditor may be able to satisfy himself by the application of other auditing procedures. If he is able to do so there is, in effect, no limitation on the scope of the examination and reference to alternative procedures is not required, except in those cases where confirmation of receivables or observation of the taking of inventories has been omitted with respect to the latest balance sheet. In these two cases the independent auditor should refer in the scope paragraph to the omission of customary procedures even when he is able to satisfy himself by the application of other auditing procedures. Where the independent auditor has been able to satisfy himself by other procedures he should so

state in the scope paragraph but he should not refer to them in the opinion paragraph of his report.

28. It should be noted that the omission of these procedures at the beginning of the year is not required to be disclosed in situations where the independent auditor has satisfied himself by other auditing procedures. However, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

29. Where he is unable to satisfy himself by the application of other auditing procedures, the independent auditor should indicate clearly in the scope (or middle) paragraph the limitations on his work and, depending on the materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion on the financial statements taken as a whole. An illustration follows:

> (Scope paragraph)
> We have examined the balance sheet of XYZ Company as of September 30, 1963, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.
>
> (Middle paragraph)
> Because we were not engaged as auditors until after September 30, 1962, we were not present to observe the physical inventory taken at that date and we have not been able to satisfy ourselves concerning inventory quantities by other procedures. The beginning inventory has a significant effect on the results of operations for the year. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings for the year ended September 30, 1963.
>
> (Opinion paragraph)
> In our opinion, the accompanying balance sheet presents fairly the financial position of the Company at September 30, 1963, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.
>
> (Note: It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.)

Restrictions Imposed by Clients

30. When a qualified opinion is expressed because the scope of the examination was restricted, the qualification should relate to the items in the statements on which an opinion cannot be expressed, rather than to the restriction, as such. For example the report may read:

> (Scope paragraph)
> . . . and such other auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.
>
> (Middle paragraph)
> In accordance with your instructions, we did not request any owners to confirm their balances of accumulated storage charges. Accordingly, we do not express an opinion as to accumulated storage charges, stated as $ . . ., which amount enters into the determination of financial position and results of operations.
>
> (Opinion paragraph)
> In our opinion, with the exception stated in the preceding paragraph, the accompanying . . .

Such wording would appear to be preferable to "Except for the above-mentioned limitation on the scope of our examination, in our opinion . . . ." which bases the exception not on a possible material effect but on the restriction. Uncertainties are present when limitations on the scope of the examination have been imposed, but such uncertainties are not of the nature and type which permit the use of "subject to" in qualifying the opinion (see page 58).

31. Restrictions imposed by clients on the scope of the examination most commonly concern the omission of the observation of inventory taking or the confirmation of receivables by direct communication. Generally, in such cases when inventories or receivables are material the independent auditor should disclaim an opinion on the financial statements taken as a whole (see page 59). An illustration follows:

> (Scope paragraph)
> . . . and such other auditing procedures as we considered neces-

sary in the circumstances, except as noted in the following paragraph.

(Middle paragraph)
In accordance with your instructions we were not in attendance at the taking of the physical inventory as of November 30, 19___. Accordingly, we do not express any opinion concerning such inventory stated at $________.

(Opinion paragraph)
Because the inventory at November 30, 19___ enters materially into the determination of financial position and results of operations, we do not express an opinion on the accompanying financial statements taken as a whole.

Part of the Examination made by other Independent Auditors

32. In reporting on financial statements, the independent auditor may not have examined the financial statements of one or more subsidiaries, divisions, or branches included therein, but he may have received the reports of other independent auditors with respect to such statements. Similar situations are often present in the case of business combinations. In these situations, questions arise as to the extent of the responsibility of the independent auditor reporting on the consolidated or combined statements with regard to such reports of other auditors and the financial statements covered thereby. In such cases, the principal auditor is usually willing (after following certain procedures described later) to utilize the report of the other independent auditor for the purpose of expressing his opinion on the consolidated or combined statements, but he is unwilling (unless he otherwise states*) to assume responsibility for the perform-

*However, as to filings with the Securities and Exchange Commission, Rule 2-05 of Regulations S-X states: "If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificates of such other accountant shall be filed . . .; however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him."

ance of the work (to the same extent as though he had performed that work himself) which served as a basis for the opinion of the other auditor. Such utilization is considered reasonable in these circumstances (and in accordance with generally accepted auditing standards) and the principal auditor may appropriately express an unqualified opinion on the fairness of the consolidated or combined statements without assuming responsibility for the report or work of the other independent auditor, provided the basis for his opinion is adequately described. This description should include a statement in the scope paragraph or in the opinion paragraph to the effect that in the formation of his opinion, amounts applicable to the entities examined by the other independent auditor were included solely upon the basis of the report of such other auditor (see pages 59, 68).

33. Before he utilizes the report of another independent auditor for this purpose, the principal auditor should make such inquiries or adopt such measures as, in his judgment, are appropriate to satisfy himself as to the independence and professional reputation of the other auditor. If the other independent auditor's primary place of practice is outside of the United States, the principal auditor should also satisfy himself that the other auditor is familiar with, and will report in accordance with, auditing standards and accounting principles generally accepted in the United States. He should also take whatever action he deems essential to assure the co-ordination of his activities with those of the other independent auditor to achieve a proper review of the matters affecting consolidation of the financial statements, such as arrangements for evaluating the company's elimination of intercompany transactions, uniformity of accounting practices, etc. In some cases he may need to issue instructions to, or make periodic visits with, the other independent auditor. Despite the foregoing, the other independent auditor remains responsible for the performance of his own work and for his opinion, and the principal auditor assumes no responsibility in this connection except for the matters heretofore discussed in this paragraph.

34. The following language is considered appropriate where

the principal auditor is utilizing the reports of other independent auditors:

> We have examined the consolidated balance sheet of X Company and subsidiaries as of November 30, 19__ and the consolidated statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements were examined by other certified public accountants whose report thereon has been furnished to us.* Our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon such report.
>
> In our opinion, the accompanying consolidated financial statements present fairly . . .

As an alternative, reference to the report of the other independent auditor as the basis, in part, for the opinion expressed may be placed in the opinion paragraph rather than in the last sentence of the scope paragraph. An illustration follows:

> (Opinion paragraph)
> In our opinion, based upon our examination and the aforementioned report of other certified public accountants, the accompanying consolidated financial statements present fairly . . .

35. If the principal auditor is unwilling to utilize the report of the other independent auditor in these cases, he should appropriately qualify or disclaim his opinion on the fair presentation of the consolidated financial statements (disclosing the percentages of consolidated assets and revenues which are qualified†) and give his reasons. The use of "except for" is recommended when the intention is to qualify the opinion.

36. In some instances the principal auditor may be willing to assume responsibility for the work of another auditor to the

*The auditor may prefer to modify the introductory sentence to the effect that he has not examined the financial statements of B Company.

†There is no need to make this disclosure if a qualification is not intended. Some independent auditors may, however, prefer to make this disclosure in all cases.

same extent as though he had performed the work himself. This would usually be the case when:

(a) the principal auditor has engaged the other auditor as his agent; or

(b) The other independent auditor is an affiliated or correspondent firm whose work is usually accepted by the principal auditor; or

(c) The principal auditor has made sufficient review of the other auditor's work to justify accepting full responsibility; or

(d) The amounts are immaterial.

When the principal auditor assumes responsibility for such work, he need make no reference to the other independent auditor in either the scope or opinion paragraph of his report. If reference is made, he should state that he is assuming responsibility for such work.

FAIRNESS OF PRESENTATION

Lack of Conformity with Generally Accepted Accounting Principles

37. Whenever financial statements deviate materially from generally accepted accounting principles, the issuance of a qualified opinion or an adverse opinion is required by the first reporting standard. Thus, when the independent auditor believes the presentation of a material item to be at variance with generally accepted accounting principles, he should qualify his opinion or, if he regards the effect of such variance as sufficiently material, express an adverse opinion. The basis for the qualified or adverse opinion should be clearly stated. Illustrations follow:

> Although the proceeds of sales are collectible on the installment basis over a five-year period, revenue from such sales is recorded in full by the Company at time of sale. However, for income tax purposes, income is reported only as collections are

received and no provision has been made for income taxes on installments to be collected in the future, as required by generally accepted accounting principles. If such provisions had been made, net income for 1961 and retained earnings as of December 31, 1961 would have been reduced by approximately $______ and $______, respectively, and the balance sheet would have included a liability for deferred income taxes of approximately $______.

Qualified Opinion

In our opinion, except that provision has not been made for additional income taxes as described in the foregoing paragraph, the accompanying financial statements present fairly . . .

Adverse Opinion

Because of the materiality of the amounts of omitted income taxes as described in the preceding paragraph, we are of the opinion that the financial statements do not present fairly the financial position of X Company at December 31, 1961 or the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Regulated Companies

38. The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include public utilities, common carriers, insurance companies, financial institutions, and the like.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies, and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or adverse opinion on such statements. However, an adverse opinion may be accompanied by a piecemeal opinion on the unaffected items in the statements or on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

39. It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and nonregulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. It should also be recognized that accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses and that the imposition of such accounting requirements does not necessarily mean that they conform with generally accepted accounting principles.

40. In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

Inadequate Disclosure

41. Information essential for a fair presentation should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. When the client declines to disclose data considered essential to a fair presentation or to incorporate it by reference in the notes, the independent auditor should provide the necessary supplemental information in his report, usually in a middle paragraph, and appropriately qualify his opinion.

42. An illustration of appropriate wording in such instances follows:

(Middle paragraph)
On January 15, 1962, the company issued debentures in the amount of $________ for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 1961.

(Opinion paragraph)
In our opinion, the accompanying financial statements, except for the omission of the information in the preceding paragraph present fairly . . .

43. There may be instances where the independent auditor may wish to include in his report additional explanatory matter (which is not required for adequate disclosure) to highlight certain circumstances or to aid in the interpretation of the financial statements. Since such additional disclosure is not intended to qualify the scope of examination or the opinion on the statements, no reference thereto should be made in the opinion paragraph of the independent auditor's report.

Lack of Consistency

44. In considering qualifications based on lack of consistency in the application of generally accepted accounting principles, reference should be made to chapter 8, page 42.

Unusual Uncertainties as to the Effect of Future Developments on Certain Items

45. The management of a company ordinarily is expected to evaluate matters affecting financial position and results of operations. In cases where the probable effects of a matter are not reasonably determinable at the time of the opinion, such as in the case of certain lawsuits, tax matters, and other contingencies which may have a material effect upon the financial statements, and the final outcome is dependent upon the decision of parties other than management, the independent auditor should appropriately qualify his opinion. In such instances use of the phrase "subject to" is appropriate. An example follows:

(Opinion paragraph)
In our *opinion*, subject to any adjustments to the balance sheet and statement of retained earnings which may result from the final determination of the company's income tax liability for prior years as indicated in Note A to the financial statements, the accompanying financial statements present fairly . . .

Note A: The Company is presently contesting deficiencies in consolidated federal income taxes proposed by the Internal Revenue Service for the years 1958 to 1960, inclusive, in the aggregate amount of $________, exclusive of interest. The point in question is one on which there are conflicting federal court decisions and on which further litigation may be required; consequently it is impossible to determine the extent of the Company's liability, if any, at this time. No provision has been made for this contingent liability.

46. Occasionally, uncertainties arising from questions of valuation or realizability of assets dependent upon management's judgment may require a qualification of opinion. In such cases, use of the phrase "subject to" is also considered appropriate. For example:

(Opinion paragraph)
In our opinion, subject to the successful conclusion of X project and ultimate recovery thereby of the related deferred research and development costs in the amount of $________ described in Note ___, the accompanying financial statements . . .

47. In some instances where the outcome of a matter is uncertain, the amount concerned may be so material that a qualified opinion is inappropriate. An example of such a situation would be a case in which the company is a defendant in a suit claiming damages of a very large amount in relation to the company's net assets and there is considerable uncertainty as to the outcome of the suit. In such cases, the facts may be disclosed in a middle paragraph of the independent auditor's report and the disclaimer of opinion may read as follows:

(Opinion paragraph)
Because of the possible material effect on the financial state-

ments of the above-mentioned lawsuit, the outcome of which is uncertain, we do not express any opinion on the company's financial statements taken as a whole.

Opinions on Prior Year's Statements

48. Where financial statements for the prior year are presented for comparative purposes the independent auditor need not extend his opinion to cover them; where he has not made an examination of the prior year's statements, there should be appropriate disclosure in the statement or in the auditor's report. Where the independent auditor presently has significant exceptions or reservations as to the prior year's statements, he should make appropriate disclosure in his report. Where he has made an examination for the prior year, he may prefer to disclose this fact by an addition to the standard scope paragraph stating that he has previously examined and reported on the prior year's statements.

CHAPTER 11

Reporting on Subsequent Events

1. An independent auditor's report is ordinarily rendered in connection with financial statements which purport to present financial position at a stated date and results of operations for a period ended on that date. Such financial statements are essentially historical in character. Financial statements for a given period represent one installment in the financial history of a business enterprise. They are so considered by the auditor in making his examination and in expressing his opinion with regard to the statements. However, events or transactions sometimes occur subsequent to the balance-sheet date which may have a material effect on the financial statements or which may be important in connection with consideration of the statements and, therefore, require adjustment or annotation of the statements.

2. A considerable portion of the independent auditor's examination must necessarily take place after the balance-sheet date. Although the independent auditor has no duty to extend the usual audit procedures to cover transactions of the subsequent period, his audit program ordinarily includes, (a) certain procedures which ordinarily are carried out after the balance-sheet date (such as cash cut-offs, review of subsequent collections, confirmation follow-ups, etc.), and (b) certain general proce-

dures which normally are continued throughout his examination (such as reading available minutes and interim reports, discussions with management, etc.).

The Responsibility for Reporting

3. The independent auditor's responsibility for reporting with regard to subsequent events or transactions is directly related to the third reporting standard, which states that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The independent auditor should consider subsequent events and require, as appropriate, adjustment of the accounts or disclosure of those matters essential to proper interpretation of the financial statements being presented.

Types of "Subsequent" Events or Transactions

5. In general, there are three types of subsequent events or transactions.

6. Subsequent events of the first type are those which affect the financial statements directly and should be recognized therein. If subsequent information is acquired which would have been utilized had it been available at the balance-sheet date, appropriate adjustments should be made in the financial statements. Examples are collection of receivables, or settlement or determination of liabilities on a substantially different basis from that previously anticipated.

7. Subsequent events of the second type are those which have no direct effect on the financial statements of the prior year but their effects may be such that disclosure is advisable. These do not require adjustment. Examples of this type of transaction or event are the sale of a capital stock issue, or large bond issue with restrictive covenants, purchases of businesses, or serious damage from fire, flood or other casualty.

8. Subsequent events of the third type are those not likely to require disclosure in financial statements; for example nonaccounting matters such as war, legislation, management changes,

product changes, strikes, unionization, marketing agreements, and loss of important customers. Disclosure of such conditions or events frequently creates doubt as to the reason therefor, and inferences drawn could be misleading as often as they are informative. However, in rare cases they may have such weighty effects as to require disclosure.

Auditing Procedures which Extend into the Subsequent Period

9. The independent auditor does not ordinarily have the responsibility for extending the usual auditing procedures to transactions of any specific period of time subsequent to the balance-sheet date. However, as part of the examination of the financial statements for the period ended on the balance-sheet date, the usual auditing procedures include the reading of available minutes of meetings and interim company statements, and certain procedures (see paragraph 2a) which are carried out after the balance-sheet date. The auditor should inquire of management whether any event or transaction has occurred after the balance-sheet date which is material in relation to the financial statements. His procedure should also include follow up of the status of items included in or excluded from financial statements on the basis of tentative data. These procedures are illustrative, and although usually appropriate are not always mandatory, or all-inclusive.

10. There is no predetermined period, after the balance-sheet date, with which the auditor must be concerned in completing various phases of his examination. The duration of this period will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. Also, all audit procedures are not carried out at the same time and some phases of an examination will extend in varying degrees to transactions of the subsequent period, whereas others will be substantially completed on or before the balance sheet date. Accordingly, the independent auditor's contact and familiarity with transactions of the subsequent period ordinarily will be progressively less as he approaches completion of the

various audit procedures which do extend into the subsequent period.

11. When the report of an independent auditor is included in a filing with the Securities and Exchange Commission under one of the federal securities statutes, his responsibility with respect to subsequent events is basically the same as that outlined in preceding paragraphs. In addition, the provisions of the Securities Act of 1933 dealing with possible liability of an independent auditor acting as an expert in a registration statement extend the period of time for which the auditor has a responsibility with respect to subsequent events to the effective date of the registration statement.

12. Section 11 of the Securities Act of 1933 provides in effect that, among other persons, no independent auditor shall be liable, as provided therein, if such auditor shall sustain the burden of proof that as to the part of the registration statement purporting to be made on his authority as an expert,

> . . . he had, *after reasonable investigation,* reasonable ground to believe and did believe, *at the time such part of the registration statement became effective,* that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .

13. To sustain the burden of proof that he has made a "reasonable investigation" the auditor should supplement his audit procedures by performing certain additional procedures with respect to subsequent events up to, or reasonably close to the effective date, to the extent reasonable and practicable in the circumstances. The responsibility for disclosure of subsequent events must, as a practical matter, decrease following the close of the field work and, subsequent to that time, the independent auditor must rely, for the most part, on inquiries of responsible officials and employees. Under ordinary circumstances the additional procedures should include the following:

(1) Read the entire prospectus and review other pertinent portions of the registration statement.

(2) Read the latest available interim financial statements in conjunction with similar statements of an appropriate prior period or periods.

(3) Read the available minutes of meetings of stockholders, directors and committees of officers or directors, as appropriate; as to meetings for which minutes are not available inquire as to matters dealt with at such meetings.

(4) Obtain a letter of representation from an officer (or officers) as to whether or not there have occurred any events subsequent to the date of the financial statements included in the registration statement and reported upon by the independent auditor, which, in the officer's opinion, would have a material effect upon those financial statements or would require mention in the notes thereto; if such a letter has previously been obtained as a part of the examination, obtain written confirmation that there have been no material changes to the date of inquiry.

(5) Inquire of officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

   a. whether the principal items in the latest interim financial statements mentioned in (2) above were treated in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the latest period reported on by the auditor

   b. whether all adjustments necessary for a fair presentation of the financial position at the interim date and the results of operations for the interim period have been made and reflected in such interim financial statements

   c. whether any adjustments other than for normal recurring items had been made during the interim period or to the date of inquiry

d. whether any substantial contingent liabilities or commitments existed at the date of the interim financial statements or at the date of inquiry; where appropriate, this inquiry should also be directed to legal counsel.

e. whether there was any material adverse change in the financial position or results of operations subsequent to the date of the financial statements covered by the report of the auditor, or any change in the capital stock or long-term debt, to the date of inquiry

f. the current status of items which were accounted for on the basis of tentative, preliminary or inconclusive data.

Reports by Predecessor Auditors

14. It is not unusual for a registration statement filed with the Securities and Exchange Commission to contain the reports of two or more independent auditors on their examinations of different periods included in the summary of earnings or the statements of income and retained earnings. An auditor who has not examined the financial statements for the most recent audited period included in the registration statement has a responsibility for events subsequent to the date of the financial statements on which he is reporting which continues to the effective date. This responsibility is discharged by:

(1) Reading the entire prospectus and reviewing other pertinent portions of the registration statement.

(2) Obtaining a letter of representation from the successor independent auditor as to whether or not his examination (including his procedures with respect to subsequent events) disclosed any subsequent events which, in his opinion, might have a material effect on the financial statements reported on by the prior auditor or would require mention in the notes thereto.

Dating the Report

15. In general, the date of completion of all important audit procedures should be used as the date of the independent auditor's report. In most cases this date will coincide with the completion of his work in the client's office.

16. In those cases in which the independent auditor's report is dated substantially later than the date of completion of all important audit procedures, the independent auditor may find it desirable to state that his report is based on an examination which was completed at an earlier date. However, he may find it practicable and consider it preferable to continue inquiry (but not examination) up to the date of his report and avoid the necessity of a special comment as to the date.

17. Long-form reports are often prepared at a date subsequent to the issuance of the short-form report from data obtained during the examination which was the basis for the issuance of his short-form report or opinion. It is the practice of many independent auditors to give the long-form report a date the same as the date of the short-form report for the purpose of removing any intimation that further audit work has been done. In some cases the report is dated at the time of issuance and such date with the added words "as of ...." which latter date is the date of the first delivered report or opinion.

18. If these dating practices are not observed, care should be taken that the comments in the long-form report contain reference to the issuance of the earlier-dated short-form report with proper notation that the subsequent report is based on the work then performed. The independent auditor has no duty to make further investigation or inquiry as to events which may have occurred during the period between the times of issuance of his two reports provided the second report does not contain any indication of such subsequent examination.

19. The independent auditor has usually issued his report on the financial statements for the year at a date prior to the filing of an annual report (e.g., Form 10-K) with the Securities and Exchange Commission. It is customary and proper for the auditor to use the same date on his report included in the Securities

and Exchange Commission filing as he used in reporting on the financial statements previously released. Use of the original date removes any implication that records, transactions or events after this date have been examined or reviewed. The independent auditor in such a situation has no responsibility to make a further investigation or inquiry as to events which may have occurred between the time of issuance of his report on the financial statements initially released and the issuance of his report on the financial statements included in the annual report to the Securities and Exchange Commission.

20. In case a subsequent event of the first type discussed previously (one requiring recognition in the financial statements) occurs between the date of first release of the report on financial statements and the filing date of the annual report and comes to the attention of the auditor, appropriate adjustments should be made in the financial statements with disclosure of their effect. The report of the independent auditor may then bear a current date, in which case the independent auditor has the same responsibility with respect to all subsequent events up to the revised date as he had up to the date of his original report. Alternatively, the report may continue to bear the original date supplemented by a current date limited specifically to the event requiring the adjustment, thus eliminating responsibility for other subsequent events.

21. In case a subsequent event of the second type (one whose disclosure is advisable) occurs during the above-mentioned period and comes to the attention of the auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Events Subsequent to the
Date of the Report of Independent
Public Accountants

Under these circumstances the report of the independent auditor would carry the same date used in reporting on the financial statements previously released.

Requests for Additional Copies of Previously Issued Reports

22. For various reasons, it is not unusual that an independent auditor is requested by his client to furnish additional copies of a previously issued report. Generally, an effort will be made by the independent auditor to have these reports identical in appearance and date, and, therefore, in the same condition as if the additional copies had been initially requested and furnished at the same time as the first copies were delivered. Under such circumstances, additional report copies may be delivered without further investigation or inquiry as to events which may have occurred between the date of issuance of the intial report and the request for additional copies.

23. In some unusual cases, it may not be desirable to deliver additional copies of a report as there may have been a change in the company's circumstances which has come to the attention of the independent auditor, subsequent to the issuance of the original report. In such cases it may be appropriate to issue a revised report stating that it is currently submitted under the circumstances or conditions existing at the time of first issuance but with an accompanying disclosure relating to the subsequent change.

CHAPTER 12

Long-Form Reports

1. While the accounting profession has generally adopted the short-form report in connection with financial statements intended for publication, auditors also issue a substantial number of so-called long-form reports. In addition to the basic financial statements these reports ordinarily include details of the items in these statements, statistical data, explanatory comments, other informative material, some of which may be of a nonaccounting nature, and sometimes a description of the scope of the auditor's examination more detailed than the description in the usual short-form reports. In some cases both a long-form report and a short-form report are issued on the same engagement, but in many cases the long-form report constitutes the only report issued.

2. The requirement of the fourth reporting standard that "... the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking" is applicable to both short-form and long-form reports. The language of the short-form report is generally used in long-form reports. Accordingly, because the usual short-form report covers only the basic financial statements the auditor should clearly establish his position regarding the other data in the long-form report. This may be accomplished, for example, by an explanation that:

a. his examination has been made primarily for the purpose of formulating an opinion on the basic financial statements, taken as a whole, and

b. the other data included in the report, although not considered necessary for a fair presentation of the financial position and results of operations (whether or not cross-referenced in the basic financial statements), are presented for supplementary analysis purposes, and either (1) that they have been subjected to the audit procedures applied in the examination of the basic financial statements and are, in his opinion, fairly stated in all material respects in relation to the basic financial statements, taken as a whole, or (2) that they have not been subjected to the audit procedures applied in the examination of the basic financial statements, stating the source of the information and the extent of his examination and responsibility assumed, if any.

3. If the other data are presented as a separate section of the long-form report, the above explanation may appropriately appear as a preface to it. Regardless of the method of reporting, it is of prime importance to maintain a clear-cut distinction between the management's representations and the auditor's representations.

4. Where a long-form report is co-existing with a conventional short-form report the auditor should make sure that:

a. the long-form report does not contain data which, if omitted from the short-form report, might support a contention that the short-form report was misleading because of inadequate disclosure of material facts known to the independent auditor; and

b. none of the comments or other data contained in the long-form report lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations.

5. In addition, the auditor must consider whether the long-form report, taken by itself, contains other financial data in such form as to support a contention that he has made *factual* repre-

sentations with respect to the financial statements or books of account rather than expressed an *opinion* on financial data consisting of management representations.

6. The concept of management's basic responsibility for financial statements and of the auditor's responsibility being confined to his opinion on such statements has become firmly established since the general adoption of the conventional short-form report. Under this concept, the independent auditor is expressing his professional opinion and is not "certifying" to facts true to his own knowledge. This same basic concept underlies the long-form report and the auditor should prepare the long-form report in a manner that makes it clear that he is expressing therein the same type of professional opinion as in short-form reports.

CHAPTER 13

Special Reports

1. The term "special reports" has reference to reports for which the wording of the usual short-form report may be inappropriate and for which special wording in the opinion section is necessary. Special reports may include:

a. Reports on financial statements of organizations which maintain their accounts and prepare their statements on a cash or other incomplete basis of accounting which is materially at variance with accounting practices customarily followed in preparing accrual basis statements. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some nonprofit organizations.

b. Reports on financial statements of some non-profit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit. These organizations may include municipalities, hospitals, co-operatives, and educational institutions.

c. Reports prepared for limited purposes, such as:
   (1) Reports that relate only to certain aspects of financial statements. These may include reports, sometimes in letter form, relating to special studies, to compliance with certain provisions of bond indentures, or to the determination of the amounts of rentals, royalties, profit-sharing bonuses and the like.

(2) Reports that are filed with various agencies on prescribed forms which provide a uniform statement presentation, in some cases with a preworded opinion or authentication. These may include reports prepared for filing with various governmental authorities or with credit and similar agencies.

2. The general standards and standards of field work, to the extent appropriate in view of the character of the engagement, are applicable to engagements involving special reports.

3. The third and fourth reporting standards are applicable to special reports. When the special report relates to statements which purport to present financial position and results of operations, the second standard of reporting as to consistency in the application of generally accepted accounting principles is applicable. When the report relates to other matters, reference to consistency is frequently appropriate, depending upon the nature of the matter reported upon. The applicability of the first reporting standard is discussed in the remainder of this chapter.

4. The first standard of reporting does not apply to statements which do not purport to present financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport, the independent auditor should make sure that there is a clear representation of what they do present and of the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. It is generally preferable in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements.

Cash-Basis Statements

5. In reporting on statements prepared on a cash basis (or substantially so) which may appear to, but do not, present financial position and results of operations, disclosure should be

made in the statements or their footnotes or, less preferably, in the independent auditor's report: (a) of the fact that the statements have been prepared on a basis of cash receipts and disbursements and (b) of the general nature of any material items omitted (such as accounts receivable and accounts payable) and, where practicable, of the net effect of such omissions on the statements. The independent auditor's opinion might then be worded somewhat as follows:

> In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at ________ 19___, arising from cash transactions, and the revenues collected and expenditures made by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year.

6. Where the independent auditor thinks that misleading inferences may still be drawn from the statements, he should include an explanation in his report that the statements do not present financial position and results of operations. This might be accomplished by a middle paragraph worded somewhat as follows:

> Because of the omission of accounts receivable and accounts payable, it is our opinion the accompanying statements do not present the financial position or results of operations of the company.

Modified Accrual Basis Statements

7. In reporting on statements prepared on a modified accrual basis of accounting, which purport to present financial position and results of operations, the independent auditor may conclude that the resulting statements are materially incomplete or were prepared in accordance with accounting practices materially at variance with those customarily followed in preparing accrual basis statements. In such cases the nature and, where practicable, the amounts of the major variances should be disclosed and the independent auditor should qualify his opinion or express an adverse opinion.

Nonprofit Organization Statements

8. If the statements are those of a nonprofit organization, they may reflect accounting practices differing in some respects from those followed by enterprises organized for profit. In many cases generally accepted accounting principles applicable to non-profit organizations have not been clearly defined. In those areas where the independent auditor believes generally accepted accounting principles have been clearly defined, he may state his opinion as to the conformity of the financial statements either with *generally accepted accounting principles* or (less desirably) with *accounting practices* for nonprofit organizations in the particular field (e.g., hospitals, and educational institutions), and in such circumstances he may refer to financial position and results of operations. In those areas where he believes generally accepted accounting principles have not been clearly defined, the provisions covering special reports as discussed under cash basis and modified accrual basis statements are applicable.

Incomplete Financial Presentations

9. Special reports in which incomplete financial presentations or no financial presentations are made (e.g., calculations of royalties, profit-sharing bonuses, rentals, etc.) should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the independent auditor's opinion, it is presented fairly on that basis.

10. There may be occasions when it is appropriate for the auditor to report upon conformity of incomplete financial presentations with generally accepted accounting principles; for example, the determination of working capital under a bond indenture. There may be other occasions, where the independent auditor expresses an opinion as to the adequacy or reasonableness of specific accounts, such as the allowance for doubtful accounts receivable or the liability for income taxes. The usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements

taken as a whole and not with respect to incomplete presentations or specific accounts. Accordingly, where the situation is such that an independent auditor considers it appropriate to express an opinion on an incomplete financial presentation, he should be cognizant of the added responsibility he may thereby be assuming and the possible necessity of extending the scope of his examination (see chapter 10, Piecemeal Opinions, page 61).

Prescribed Audit Report Forms

11. Statements prepared on printed forms designed by the authorities with which they are to be filed may require classifications or other similar procedures that, in the independent auditor's opinion, do not fairly present the financial position or results of operations of the company filing the statements, even though they purport to do so. Also, such forms may involve the additional problem of conforming the prescribed auditor's opinion or certificate to professional standards. Many of these forms are not acceptable to the independent auditor because the prescribed uniform financial presentation conflicts with fair presentation in the particular case, or the prescribed language of the opinion calls for assertions by him that are not part of his functions and responsibilities as an independent auditor. Some forms can be made acceptable by interpolating additional captions or wording; others can be made acceptable only by complete revision. Whenever the printed forms call upon the independent auditor to make an assertion which he believes he is not justified in making, he has no alternative but to reword them or to submit his separate report. Such revised or separate reports are generally accepted by the authorities with which they are filed.

Historical Background

The "Bulletins" of 1917, 1918, 1929 and 1936

In 1917 the American Institute of Certified Public Accountants, then known as the American Institute of Accountants, at the request of the Federal Trade Commission, prepared "a memorandum on balance-sheet audits," which the Commission approved and transmitted to the Federal Reserve Board for the latter's consideration. The Federal Reserve Board, after giving the memorandum its provisional endorsement, caused its publication in the *Federal Reserve Bulletin* of April, 1917; reprints therefrom were widely disseminated for the consideration of "banks, bankers, banking associations; merchants, manufacturers and associations of manufacturers; auditors, accountants and associations of accountants" in pamphlet form with the title of "Uniform Accounting; a Tentative Proposal Submitted by the Federal Reserve Board." In 1918 this pamphlet was reissued under the same sponsorship, with its title changed to "Approved Methods for the Preparation of Balance-Sheet Statements," with practically no change from the 1917 issue except that, as indicated by the respective titles and corresponding change in the preface, instead of the earlier objective of "a uniform system of accounting to be adopted by manufacturing and merchandising concerns" the later objective was "the preparation of balance-sheet statements" for the same business entities.

In 1929 a special committee of the American Institute of Certified Public Accountants undertook the revision of the earlier pamphlet in the light of the experience of the decade that had elapsed; again under the auspices of the Federal Reserve Board, the revised pamphlet was promulgated in 1929 under the title of "Verification of Financial Statements."

The preface of the 1929 pamphlet spoke of its predecessors as having been criticized by some accountants for being, on the one hand, "more comprehensive than their conception of the so-called balance-sheet audit," and, on the other hand, by other accountants because "the procedure would not bring out all the desired information." This recognition of opposing views evidenced the growing realization of the impracticability of a uniform procedural pattern to fit the wide variety of situations encountered in actual practice. Of great significance is the appearance in the opening paragraph of "General Instructions" in the 1929 publication of the statement:

"The extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor."

Between the years 1932 and 1934, there was an interchange of correspondence, dealing with both accounting and auditing matters, between the Institute's special committee on co-operation with stock exchanges and the committee on stock list of the New York Stock Exchange. The views expressed in the correspondence were an important development in the recognition of the position of accountancy in finance and business. The series of letters was published in 1934 under the title *Audits of Corporate Accounts.*

Some years later, in 1936, a committee of the American Institute of Certified Public Accountants prepared and published a further revision of the earlier pamphlets under the title of "Examination of Financial Statements by Independent Public Accountants." It is interesting to observe as a matter of historical development that, although in this 1936 revision the American Institute of Certified Public Accountants freely availed itself of the views of persons outside the ranks of the profession whose opinions would be helpful, the authority behind, and responsibility for, the publication of the pamphlet rested wholly with the American Institute of Certified Public Accountants as the authoritative representative of a profession that had by that time become well established in the business community. In the 1936 revision, aside from the very briefly noted "Modifications of Program for Larger or Smaller Companies," the detailed procedures set forth again were definitely and restrictively stated to be an "outline of examination of financial statements of a small or moderate size company." Moreover, the varying nature and extent of such examinations were predicated upon the purpose of the examination, the required detail to be reported upon, the types of business and, most important of all, the system of internal check and control; the variations in the extent of the examination and of the test checks used were specifically related to "the size of the organization and the personnel employed" and were indicated to be "essentially a matter of judgment which must be exercised by the accountant."

It is possible from the foregoing narrative to trace the development of the profession's view of an audit based on the experience of three decades. The very succession of titles is illustrative. The earliest ambition for "uniform accounting" was quickly realized to be unattainable as an objective, and the same listed procedures were related instead to "balance-sheet statements." Then, with the gradually greater emphasis on periodic earnings, the earlier restrictive consideration of the balance-sheet was superseded in the 1929 title, "Verification of Financial Statements," by according the income account at least equal status. When in turn the 1936 revision was undertaken, there had culminated a growing realization that with the complexity of modern business and the consequent need of the independent auditor to rely on a system of carefully devised testing for his justification in accepting the representations of the examinee, such a word as "verification" was not an accurate portrayal of the independent auditor's function. The bulletin of that year accordingly was stated to cover an "examination" of financial statements.

Statements on Auditing Procedure

The committee on auditing procedure had its beginning in 1939 when, on January 30, the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year the report "Extensions of Auditing Procedure" of this special committee was adopted by the Council of the Institute and authority given for its publication and distribution, and in the same year the bylaws were amended to create a standing committee on auditing procedure.

In 1941 the executive committee authorized the issuance to Institute members, in pamphlet form, of the "Statements on Auditing Procedure," prepared by the committee on auditing procedure, previously published only in *The Journal of Accountancy.*

The "Statements on Auditing Procedure" are designed to guide the independent auditor in the exercise of his judgment in the application of auditing procedures. In no sense are they intended to take the place of auditing textbooks; by their very nature textbooks must deal in a generalized manner with the description of procedures and refinement of detail rather than the wide variety of those differing situations encountered in actual practice which require the independent auditor to exercise his judgment.

It was largely to meet this need that the Institute inaugurated the series of Statements on Auditing Procedure. The first of these statements presented the report of the original special committee, as modified and approved at the Institute's annual meeting on September 19, 1939, and promulgated under the title of "Extensions of Auditing Procedure." It was subsequently amended by Statement No. 12 issued in October 1942, and by Statement No. 23 (Revised) issued in December 1949. These statements likewise received formal approval at annual meetings on October 1, 1942 and November 1, 1949, respectively. The membership of the Institute has not acted on any of the other statements issued by the committee.

Statement No. 1 presented certain conclusions drawn from the experience and tradition of the profession which largely furnished the foundation for the committee's present structural outline of auditing standards; the other Statements on Auditing

Procedure appropriately fit into the framework of that structural outline.

The "Codification of Statements on Auditing Procedure" was issued by the committee on auditing procedure in 1951 to consolidate the features of the first twenty-four pronouncements which were of continuing usefulness. In the process of codification:

a. Statements No. 1, 3, and 12 were clarified to eliminate ambiguities respecting the expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion. Effect was also given to Accounting Series Releases No. 62 and 70 of the Securities and Exchange Commission, the former relating to the independent auditor's responsibility for summaries of earnings in registration statements and prospectuses and the latter to an amendment of Rule 2-02 of Regulation S-X.

b. The recommendations of Statements No. 7, 9, 10, 15, 17, 20, and 21 were omitted because they applied to special situations, such as those which arose in World War II.

Since the issuance of the Codification in 1951, eight additional statements on auditing procedure, Nos. 25-32, have been issued by the committee on auditing procedure.

While it is not practicable, because of the wide variety of conditions encountered, to issue anything like an "all purpose" program of auditing procedures, it is possible to formulate a pronouncement with regard to the auditing standards required to be observed by the independent auditor as he exercises his judgment in selecting the procedures to be used and in determining the extent to which he will apply such procedures. It is the intent of the American Institute of Certified Public Accountants, through its committee on auditing procedure, to continue to issue Statements on Auditing Procedure. Such statements, covering recommended auditing procedures, represent the opinion of the committee on the particular matters recited therein. While it is true that circumstances alter cases and that with any important variation in conditions there may also properly be changes in the procedures recommended or in the extent of their application, it is nevertheless the view of the committee that such pronouncements point the general direction in which conclusions might be expected to lie under circumstances not radically different; while they do not pre-empt the independent auditor's judgment, they do guide his judgment. The independent auditor should recognize that the exercise of such professional judgment may lead him to perform additional procedures which go beyond those recommended in the committee's pronouncements.

Generally Accepted Auditing Standards

When the Securities and Exchange Commission adopted the requirement that a representation as to compliance with generally accepted auditing standards be included in the independent auditor's report relating to financial statements filed with the Commission, it became apparent that a pronouncement was needed which would define these standards. Accordingly, the committee undertook a special study of auditing standards (as distinguished from auditing procedures) and submitted a report that was published in October 1947 under the title "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope." The recommendations of this brochure ceased to be tentative when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards appearing therein. In 1954 the "tentative" brochure was supplanted by the booklet *Generally Accepted Auditing Standards – Their Significance and Scope* which was issued as a special report of the committee on auditing procedure. This pronouncement also gave recognition to the approval of Statement on Auditing Procedure No. 23 (Revised), "Clarification of Accountant's Report When Opinion Is Omitted," and the issuance of the "Codification."

Other Procedural Booklets

In the years since the Institute issued its first bulletin, in 1936, the complexities of modern business have increased the diversity of conditions encountered by the independent auditor as he examines financial statements of concerns of different size, industry, type of organization and location. It was concluded that no useful purpose would be served by another revision of listed procedures when any particular list could, of necessity, be narrowly applicable to only a small segment of the industrial field. Instead, therefore, of any such revised bulletin, the Institute in responding to requests for procedural brochures has issued a number of booklets directed to certain specific areas of auditing procedure. They include:

Institute Committee Publications

"Audits of Brokers or Dealers in Securities," a pamphlet prepared by the committee on auditing procedure, outlining procedures for independent audits of brokers and dealers in securities and commodities;

"Auditing in the Construction Industry," a pamphlet prepared by the committee on co-operation with surety companies, outlining special features of independent audits of contractors;

"Audits of Savings and Loan Associations," a pamphlet prepared by the committee on savings and loan auditing, outlining procedures for independent audits of savings and loan associations.

Institute Staff Publications

"Case Studies in Auditing Procedure," a series of case studies illustrating the auditing procedures applied in actual examinations;

"Case Studies in Internal Control," two case studies illustrating the independent auditor's evaluation of internal control and the application of his findings in actual examinations;

"Special Reports—Application of Statement No. 28," a sort of "how to do it" publication discussing the special reporting features involved in each of a number of different types of circumstances referred to in "Statements on Auditing Procedure No. 28—Special Reports."

"Case Studies in the Observation of Inventory," a booklet outlining the procedures followed in observing the taking of the physical inventories of seven different business entities.

The committee on auditing procedure in 1948 made a comprehensive study of internal control, a subject which is of great importance to the auditor because of the effect of internal controls on audit procedures. The results of this study were published under the title *Internal Control – Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant.*

List of Statements on Auditing Procedure No. 1-32

No.	*Date Issued*		*The Journal of Accountancy*
1	Oct. 1939	Extension of Auditing Procedure	Dec. 1939
2	Dec. 1939	The Auditor's Opinion on the Basis of a Restricted Examination	Dec. 1939
3	Feb. 1940	Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers	Feb. 1940
4	March 1941	Clients' Written Representations Regarding Inventories, Liabilities and Other Matters	Mar. 1941

No.	Date Issued		The Journal of Accountancy
5	Feb. 1941	The Revised SEC Rule on "Accountants Certificates"	***
6	March 1941	The Revised SEC Rule on "Accountants Certificates" (continued)	Apr. 1941
7	March 1941	Contingent Liability under Policies with Mutual Insurance Companies	Apr. 1941
8	Sept. 1941	Interim Financial Statements and the Auditor's Report Thereon	Dec. 1941
9	Dec. 1941	Accountants' Reports on Examinations of Securities and Similar Investments under the Investment Company Act	Feb. 1942
10	June 1942	Auditing under Wartime Conditions	Aug. 1942
11	Sept. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)	Nov. 1942
12	Oct. 1942	Amendment to Extensions of Auditing Procedure	Nov. 1942
13	Dec. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)—Face-amount Certificate Companies	***
14	Dec. 1942	Confirmation of Public Utility Accounts Receivable	Jan. 1943
15	Dec. 1942	Disclosure of the Effect of Wartime Uncertainties on Financial Statements	Feb. 1943
16	Dec. 1942	Case Studies on Inventories	***

***Not printed in *The Journal of Accountancy.*

No.	*Date Issued*		*The Journal of Accountancy*
17	Dec. 1942	Physical Inventories in Wartime	Feb. 1943
18	Jan. 1943	Confirmation of Receivables from the Government	Feb. 1943
19	Nov. 1943	Confirmation of Receivables (Positive and Negative Methods)	Jan. 1944
20	Dec. 1943	Termination of Fixed Price Supply Contracts	Feb. 1944
21	July 1944	Wartime Government Regulations	Aug. 1944
22	May 1945	References to the Independent Accountant in Securities Registrations	June 1945
23	Dec. 1949	Clarification of Accountant's Report When Opinion is Omitted (Revised)	Jan. 1948 and June 1949
24	Oct. 1948	Revision in Short-Form Accountant's Report or Certificate	Nov. 1948
25	Oct. 1954	Events Subsequent to the Date of Financial Statements	Dec. 1954
26	Apr. 1956	Reporting on Use of "Other Procedures"	May 1956
27	July 1957	Long-Form Reports	Sept. 1957
28	Oct. 1957	Special Reports	Dec. 1957
29	Oct. 1958	Scope of the Independent Auditor's Review of Internal Control	Nov. 1958
30	Sept. 1960	Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements	Jan. 1961
31	Oct. 1961	Consistency	Dec. 1961
32	Sept. 1962	Qualifications and Disclaimers	Jan. 1963

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